No. 11115

# In the United States Circuit Court of Appeals for the Ninth Circuit

AMERICAN BOX SHOOK EXPORT ASSOCIATION, A CORPORATION, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

*ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES*

## BRIEF FOR THE RESPONDENT

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## CITATIONS





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### OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 19–28) are reported at 4 T. C. 758.

### JURISDICTION

This petition for review involves income and excess profits taxes for the fiscal year ended May 31, 1941, in the respective amounts of $1,952.15 and $1,270.32. (R. 105–107.) On December 9, 1942, the Commissioner of Internal Revenue mailed a notice of deficiency to the taxpayer. (R. 8–9.) Within 90 days thereafter, i. e., on February 17, 1943, the taxpayer filed its petition with the Tax Court for redetermination of the deficiencies under Section 272 of

the Internal Revenue Code. (R. 1, 3–8.) The Tax Court entered its decision on April 11, 1945, finding deficiencies in the amounts stated above. (R. 28–29.) The petition for review by this Court was filed on July 5, 1945 (R. 105–107), pursuant to the provisions of Sections 1141–1142 of the Internal Revenue Code.

### QUESTION PRESENTED

Whether Section 22 of the Internal Revenue Code requires the taxpayer to report the income which it received in the taxable year as its gross income and, if so, whether sums it distributed to its member associations may be deducted therefrom in computing its net taxable income.

### STATUTE INVOLVED

Internal Revenue Code:

> SEC. 22. GROSS INCOME.
>
> (a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *
>
> * * * *
>
> (26 U. S. C. 1940 ed., Sec. 22.)

STATEMENT

The facts as found by the Tax Court are as follows:

The taxpayer is a corporation organized on March 26, 1940, under the general corporation laws of the State of California. Its tax returns for the year involved were prepared on the accrual basis. The taxpayer was organized to succeed an unincorporated association of the same name, which was organized in 1935. (R. 19.)

The taxpayer is a sales organization engaged in the purchase of box shook, i. e., unassembled parts of wooden boxes, exclusively for export purposes. During the fiscal year ended May 31, 1941, the year in controversy, it purchased shook from its member-stockholders only. It has twelve such members, all of which are associations engaged either in the manufacture or distribution of lumber products, or both. The shook so purchased by the taxpayer was sold by it to its customers in foreign countries. It does not make purchases from its members upon any standard rate or price basis. When an order for shook is placed by a foreign customer, the taxpayer first obtains the necessary data from the customer, including information as to specifications, shipping schedule and quantity. It then contacts its members to ascertain the "minimum satisfactory price" at which the members would agree to handle the particular order. (R. 19–20.)

These negotiations with the members usually are not reduced to writing. The taxpayer conducts its business with its members in an informal manner,

much of it being handled by telephone. After it obtains the minimum price at which the members will produce the shook, the taxpayer endeavors to secure a higher price from the customer. This usually amounts to an additional margin of from 8 percent to 10 percent of the original "minimum" price. It is added to provide against unforeseen items of expense. (R. 20.)

The members bill the taxpayer for shook sold on the basis of the "minimum" price and it settles with them currently on the basis at a discount. This is done since the final profit from the transaction cannot be determined for some time owing to the distances which the products must travel and the unforeseen expenses which may arise. (R. 20.)

Neither the articles of incorporation nor the by-laws of the taxpayer require that amounts received by it in excess of the cost of the goods sold be distributed to its members upon any patronage basis but there is an understanding between the taxpayer and its members that any amounts received in excess of actual cost, with the exception of amounts placed in a reserve for anticipated claims, is to be returned to them. (R. 20–21.)

At the close of the fiscal year the directors determined the amount of profits which could be distributed without endangering the reserve fund. These amounts were distributed to the members upon the basis of the amount of board feet of shook which each shipped during the year. On or about May 28, 1941, it made distributions to its members out of earnings of that year in the amount of $7,559.11. (R. 21.)

In its income tax return the taxpayer reported total income of $50,865.03 and net taxable income of $13,-317.66. It did not include in its gross income either the amounts distributed to the members during that year nor the sum of $4,000 entered in its books as a reserve for anticipated claims. At the hearing it conceded the non-deductibility of the latter item if it is determined that it is taxable. (R. 21.)

The Tax Court held (1) that the income received by the taxpayer was not the income of its members, and (2) that sums which it distributed to the members during the taxable year were not deductible from gross income. Accordingly it decided that there are deficiencies in income tax and excess profits tax in the respective amounts of $1,952.15 and $1,270.32. (R. 28.)

## SUMMARY OF ARGUMENT

The Tax Court correctly held that all income received by the taxpayer during the taxable year belonged to it and that no deductions could be made on account of sums distributed by it to its members. In contending otherwise, the taxpayer asserts that all of its net income belonged to its members. However, it does not now seek to have any portion of such income held tax exempt except the sums distributed to its members, and in seeking this privilege it does not rely on any specific provision of the revenue statutes. Instead it relies entirely on an "understanding" which it claims to have had with its members to the effect that it would distribute all profits in excess of expenses. The Tax Court found that there was such an understanding but held that, since it was merely an

informal arrangement not contained in any express written contract or in the articles of incorporation or by-laws, such understanding did not amount to the fixed liability required before a taxpayer may be relieved of tax on sums distributed. The Tax Court's conclusion is also supported by the evidence showing that no distributions were or could be made without action by the directors, that there was nothing to prevent the taxpayer's directors from voting regular dividends on stock, that the taxpayer had not adhered to the understanding in practice, that it was organized under the general corporation law of California rather than under the statutes providing for cooperative associations, and that it intended to and had engaged in the exporting trade for a profit, as any other business corporation would have done. Accordingly, the Tax Court's decision is amply supported by the evidence, and is a correct interpretation of the law.

## ARGUMENT

### The taxpayer is subject to tax on the income which it received during the taxable year and is not entitled to deduct amounts distributed to its members during that year

The Tax Court held that all of the income which the taxpayer received during the taxable year belonged to it and was subject to tax, and that sums distributed to the taxpayer's members were not deductible in computing its net taxable income. (R. 25–28.)

In contending otherwise, the taxpayer takes the position that all of the income which it received, in excess of expenses, belonged to its members. From this it might be inferred that the taxpayer is ask-

ing to be classified as an exempt corporation or at least is contending that all of its income during the taxable year was tax exempt, but that is not the case. Thus, in order to clarify the issue, attention is called at the outset to the fact that the taxpayer does not claim to be entirely tax exempt. It filed an income tax return for the taxable year reporting $13,317.66 as its net taxable income. Moreover, when the Commissioner determined a deficiency because the taxpayer had not included in its gross income the sum of $7,559.11, which it distributed to its members, and the sum of $4,000 held as a reserve for anticipated claims, it petitioned the Tax Court only for a redetermination of such deficiency[1] (R. 3–10) and has never claimed any overpayment because of the income originally reported. Later, at the hearing, counsel for the taxpayer admitted that the $4,000 reserve fund should be included in its taxable income, if it is held to be a taxable corporation. (R. 21.) From this, it is of course evident that, notwithstanding the taxpayer's assertion that all of the net income belongs to its members, the only amount which it actually seeks to have excluded is that dis-

[1] The Commissioner asked the Tax Court to rule that the issue as to whether the taxpayer had any taxable income was not properly raised in the petition and contended that it should not be considered but the Tax Court did not choose to rest its decision on the defect in the pleadings. Accordingly, while we think the issue should have been limited to how to treat the sums distributed to the members, in view of the Tax Court's decision we have included both issues in our statement of the question and in our argument.

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tributed to the members during the taxable year, and there can now be no question as to the taxpayer's liability for tax on the income which it originally reported on its tax return.

The taxpayer will also admit that in seeking to have the sum of $7,559.11 excluded or deducted from its gross income, it is not relying on any specific provision of the revenue laws. Section 101 of the Internal Revenue Code sets forth the corporations which are tax exempt, Section 22 provides for certain exclusions from gross income and Section 23 covers deductions therefrom, but the taxpayer does not and cannot claim that any of these statutory provisions are applicable or allow it to secure the privilege it seeks. Instead the taxpayer relies entirely on "an understanding" which the taxpayer had with its members, and asserts that, because of such understanding, all of the income which it received in excess of expenses belonged to its members and should be free of tax in its hands, at least to the extent that the income was distributed during the taxable year to the members.

In some cases, such as *San Joaquin V. P. Producers' Ass'n* v. *Commissioner,* 136 F. 2d 382 (C. C. A. 9th), taxpayers have been granted tax exemption or partial exemption because of an agreement with persons with whom they have dealt that the net income shall belong to the latter. However, as we shall point out more fully below, these cases are distinguishable from the instant case in several respects, the most important being that they have involved valid legal

obligations in existence prior to the earning of the profits.

In attempting to show that there was a legally enforceable agreement here, counsel for the taxpayer points to the finding of the Tax Court that there was an understanding between the taxpayer and its members that any amounts received in excess of actual cost and necessary reserves were to be returned to the members. (R. 21.) Counsel then mistakenly assumes that the word "understanding" is necessarily synonymous with the term "valid, legal obligation", and have even stated (Br. 13) that the Tax Court "nowhere found that the contracts were not valid and enforceable." But counsel are in error. The Tax Court stated twice in its opinion (R. 23, 26), that "the understanding" here was not such a legal obligation as would support the taxpayer's contention that its net income belonged to its members. In this connection, the Tax Court discussed the evidence fully and showed how its conclusion was based on, and in complete accord with, the evidence.

In considering this matter, the Tax Court first pointed out (R. 22–23) that in order to be a true cooperative (and so be exempt from tax on income received) the taxpayer must have a legal obligation to pay over all funds received in excess of cost to the producers, and that such an obligation may arise (1) from the association's articles of incorporation, (2) from its by-laws, or (3) from some other contract. The Tax Court then stated unequivocably that it found no evidence of such a legal obligation here.

(R. 23.) After pointing out that the taxpayer was organized under the general corporation law of California, rather than the statutes providing for cooperative associations, that neither its articles of incorporation nor by-laws required distribution of profits to its members, and that there was no express written contract to that effect, it referred to the "understanding" which the taxpayer had with its members and stated that such understanding was not carried out in practice. Then returning to the question of whether the understanding was the kind of obligation which would support the taxpayer's contention here, the Tax Court emphasized its first statement by again stating (R. 26):

> * * * there was nothing in the petitioner's articles of incorporation or by-laws imposing upon it the obligation to distribute its excess revenue among its members. The question is, therefore, narrowed to whether or not such an obligation existed because of some other contract or contracts between the petitioner and its members.
>
> The petitioner contends that such a contract existed by virtue of the "understanding" between the petitioner and its members that they were to receive all the profits in excess of cost and the additions to the reserve. This contention is not borne out by the evidence. The testimony shows that it had originally been contemplated that excess revenue should be distributed by way of dividends on the stock. At a meeting of the stockholders, held May 6, 1940, a motion was made that the by-laws be amended to effect the distribution of excess revenue among the members upon the basis of

> the dollar value of shipments made by each member. This amendment was never put into effect. It was finally decided that the basis for distribution, proposed in the motion, was not practicable and that "the only fair method of distribution" was upon the basis of board feet of shook shipped by each member. However, no formal action in this regard was ever taken.

From this, it is evident that since the by-laws were not amended, dividends could have been voted on the stock as in the case of any business corporation. Indeed the taxpayer was an ordinary business corporation. It was not only organized under the general corporation law of California for the purpose of carrying on an exporting business, but it carried on such business in the way that any company would do when endeavoring to realize profits. And it did do a profitable business, At the end of the taxable year here, it had net income in the amount of $13,-317.66 in addition to the $4,000 reserve fund which it had set aside and also in addition to the amount which it had distributed to its members. The Tax Court pointed out (R. 23) that there was nothing to indicate what disposition was to be made of such income but it properly concluded that the net income could be used for payment of dividends on the stock or for any other corporate purpose. Counsel for the taxpayer, while denying that this could be done, make no comment in their brief on the failure of the taxpayer's directors to amend the by-laws so as to prevent payment of dividends in the customary

way. As to the testimony relative to the failure to make such amendment see record (pp. 50–51, 85).

There is another significant piece of evidence which the Tax Court also refers to (R. 26–27), and that is the fact that no amounts were distributable to the taxpayer's members without prior action on the part of the taxpayer's board of directors. This is of special importance because it shows that "the understanding" on which the taxpayer relied was of no effect without action by the directors. The taxpayer attempts to explain this by stating that the action of the directors was merely to determine how much of the profits should be distributed but the Tax Court did not so hold and the evidence indicates otherwise.

In the taxpayer's minutes of July 29, 1940, reference is made to the understanding that any excess income is to be distributed to the members "upon action of the organization." (R. 51.) These minutes were offered as written evidence of "the understanding." (R. 52.) Earlier, in answer to a questionnaire submitted by the Treasury Department, the taxpayer had also stated that "upon action of the organization" the excess would be distributed to its members. (R. 73–74.) Even the taxpayer's manager, in attempting to put the matter in as favorable light as possible for the taxpayer, admitted that action was always taken by the directors before every distribution and that they had to approve a distribution before it could be made. (R. 81–82.)

We submit that the evidence here amply supports the Tax Court's conclusion that the understanding

which the taxpayer had with its members was not sufficient to exempt it from taxation either entirely or on the sums distributed to its members. Accordingly this case is clearly distinguishable from *San Joaquin V. P. Producers' Ass'n* v. *Commissioner, supra.* In that case the taxpayer was organized under the Agricultural Code of California, which provides that associations organized thereunder shall be deemed non-profit. Here, as stated, the taxpayer was organized under the general corporation law and although it is claimed that the taxpayer was intended to be a non-profit organization, its application for a permit to issue shares of capital stock did not refer to its alleged non-profit purpose but stated instead that the taxpayer proposed "to transact business by purchasing box shook exclusive for export." (R. 86–87.)

Furthermore, in the *San Joaquin* case, the taxpayer's articles of incorporation provided that it should conduct and carry on its business without profit to itself and its by-laws also stated that it was organized as a non-profit cooperative association and that any net proceeds should belong to the members. Also, it was the practice of the taxpayer in that case to prorate and credit all net income, including that retained by the company, to the individual members. Consequently, this Court correctly held there that the net income, received by the taxpayer, whether distributed or not, belonged to its members and was not taxable to the association. But here, as we have already pointed out, the articles of incorporation and the by-laws were different, and there was no crediting of in-

come to the members nor any other action which would indicate that the income actually belonged to the members when received by the taxpayer.

Counsel for the taxpayer also cite (Br. 23) *United Cooperatives, Inc.* v. *Commissioner,* 4 T. C. 93, a case decided several months before the decision of the Tax Court in the instant case. Thus, if there is a conflict, the decision here, being later, should be taken as indicative of the Tax Court's interpretation of the law. However, it will be seen that the facts there are distinguishable in that the association in that case, although also organized under a general corporation law, had by-laws which required patronage dividends. The same distinction will be found in other similar cases. Thus it will be seen in all cases where the net income of cooperative associations has been held to be tax exempt or, where sums distributed by such associations as patronage dividends have been held to be deductible, there have been definite provisions in the by-laws or articles of incorporation requiring payment of such net income to the members or producers. Other factors may also be considered but to secure any tax exemption in such cases it is absolutely essential that there always be a fixed liability to distribute net profits and such liability must be in existence prior to the earning of such profits. *Cf. Co-operative Oil Ass'n* v. *Commissioner,* 115 F. 2d 666 (C. C. A. 9th); *Farmers Union Co-Op. Co.* v. *Commissioner,* 90 F. 2d 488 (C. C. A. 8th); *Farmers Union Cooperative S. Co.* v. *United States,* 25 F. Supp. 93 (C. Cls.). And it will be seen that in these cases the liability was fixed by the articles of incorporation or by-laws or both.

In the instant case, instead of there being a provision either in the articles of incorporation or the by-laws for distributions to patrons or for distribution on the basis of production there was nothing but an informal understanding which, as the Tax Court properly held, was not the legal obligation required. Actually such understanding, if it can be given any effect at all, is merely an arrangement for the payment of dividends to stockholders but not in proportion to the stock held. As all who received the distribution were stockholders, there was nothing objectionable about it, but the fact remains that the distribution was merely a payment in the nature of a dividend to stockholders and such payments are not deductible as ordinary and necessary expenses or for any other reason. *Cf. Cleveland Shopping News Co.* v. *Routzahan,* 89 F. 2d 902 (C. C. A. 6th).

In view of the taxpayer's references to the nature of the question here (Br. 7–23), we also wish to add that we agree with counsel that the question of whether the taxpayer was bound by any valid and enforceable agreement is one of law. However, counsel are in error in asserting (Br. 8) that the Tax Court's conclusions of law are contrary to its findings of fact that the taxpayer had an understanding with its members about net profits. As we have already pointed out, although the Tax Court did find that there was such an understanding, it held that this understanding was not the kind of agreement or obligation which is required in order for a taxpayer to be tax exempt. In interpreting this understanding and in reaching its conclusion, the Tax Court discussed various state-

ments in the evidence which show what action could be and had been taken by the taxpayer's board of directors and manager. (R. 23, 26–27.) Thus the basis for its conclusion or ultimate findings of fact is clear and there is ample evidence supporting such conclusion.

Apparently, the counsel for taxpayer object because some of the evidence which the Tax Court referred to in its opinion (R. 26–27) was not also set out under "Findings of Fact" but the references of the Tax Court are clearly to the facts and as these facts were taken from the evidence introduced by the taxpayer they cannot be disputed. Thus, while the Tax Court's decision can be sustained without these facts, we see no reason why they cannot be considered here as findings of the Tax Court. As this Court held in *California Iron Yards Co.* v. *Commissioner,* 47 F. 2d 514, the appellate court may consider findings of fact which are given in the opinion.

## CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted.

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